Risk Sharing and Public Finance

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Abstract

Dominant macroeconomic policy regimes are anchored on the interest based debt finance that has created a divergence between the real sector and the financial sector of the economy. Uncertainty has been growing regarding the adequacy of current policy regimes to provide sustainable solutions to contemporary economic problems and challenges, including improvement in the quality of life in addition to the traditional objective of achieving growth with price stability. Policy tools that provide an incentive structure for closing the gap between financial and real sectors of the economy and at the same time enhance social solidarity through the mutual sharing of risks and return could provide more effective means of addressing these challenges. This concept paper offers an alternative policy regime that proposes first, a monetary policy that is targeted directly at asset market activities and private sector portfolio adjustments. Secondly, it suggests mobilization of funds for financing fiscal operations based on risk sharing through sale of government low-denomination equity participation papers directly to the public tradable in secondary markets. The latter proposal is supplemented with a reform of the tax structure. The benefits include better return to savers, improved financial inclusion through broadened public participation, improved governance and positive distributional implications for current and future generations. The objective of these policy reforms is to achieve stability and growth of the real economy, without losing sight of the goal of achieving justice and equity among members of the society.

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1. Introduction

Many discourses on equity-based investment in attaining socio-economic development have so far been concentrated at the microeconomic and institutional level. Islāmic finance provides an alternative financing arrangement that does not compromise on the prohibition of interest rate based debt financing. Its growth has been significant; partly due to its value propositions that have attracted even non-Muslims. The emphasis of Islāmic finance on transparency, social responsibility and ethics in a transaction is the manifestation of Islāmic principles of equity and social justice. Additionally, these characteristics of Islāmic finance have been cited as having insulating elements against the brunt of financial crisis. Nevertheless, there is a view gaining momentum that as Islāmic finance as currently practiced is embedded in an ecosystem with deeply ingrained fixed-return financing mindset that shares the same motivation of the dominant system, it is not altogether immune to crises.

The root of the recent financial crisis runs deep into ethical, legal and economic issues. Whilst at the institutional level it is easier to implement the modalities of ethical-based finance as envisioned by Islāmic economics, it is not so at the macro level where policies and its tools hinge significantly on interest based debt financing. For instance, monetary policy is about inducing private sector portfolio adjustments by managing the money supply in the economy using the interest rate mechanism. In addition, interest rate based borrowing often funds fiscal deficits. In the search for a sustainable solution to the present day financial crisis, perhaps it is time for Islāmic finance to be taken to the next level: macroeconomic management.

Followed by the introduction, the next section begins by providing some background to the policy dilemma faced by many developing and developed countries in the wake of recent financial crises. The impetus for reform in the policy framework in the light of shortcomings of the current policy tools will be discussed in the subsequent section. The paper then goes on to review the literature on the features of an alternative macroeconomic policy design and its incentive structure. This is followed by a discussion of the proposed new Islāmic monetary and fiscal policy framework covering its objectives, operations and advantages. The final section concludes with policy recommendations.

2. Policy Dilemma

Generally, government objectives for the economy are stability and growth. In market economies, government does this by taking actions that affect private sector portfolios (in terms of consumption and investment). There are two policies to achieve these objectives – used either independently or in

combination. Using mostly the interest rate mechanism, monetary policy aims at increasing or reducing the level of supply of money, and thus the level of spending and production in the economy. Fiscal policy uses the power of the government to tax and spend as means of influencing aggregate demand and the level of economic activity.

In an idealized model, macroeconomic policies create inducements that elicit appropriate responses from participants in the economy reflecting the desired level of income, prices, and employment. These incentives are signalled through the financial sector in case of monetary policy that transmits them to the private sector to induce portfolio adjustment. However, since the objective function of the policy makers is different from that of the financial sector, more often than not, the transmission mechanism becomes impaired meaning that the policy signals are filtered by the private sector and hence, monetary policy's potency is eroded. This happened to monetary policy transmission mechanism in a number of countries during the post-crisis period when repeated monetary expansion failed to illicit desired portfolio adjustment in the private sector investment. Additionally, interest based debt instruments exacerbate income distribution bias towards higher income group. These instruments are normally sold wholesale and in large denominations such that only the more economically able segment of the population such as banks and financial institutions, high net-worth individuals or foreign investor are able to buy them. In the case of foreign creditors, resources are diverted outside the country whilst taxes are levied on the low and middle-income groups to serve these instruments. In case of domestic borrowing, the more able lend to governments while the middle or higher low-income groups are taxed to service the debt thus worsening income and wealth distribution.

2.1. Monetary Policy and the Transmission Mechanism

Current monetary policy relies on the relationship between the rate of interest and the supply of money to influence economic growth, inflation, exchange rates, and unemployment. The central bank is normally the institution that manages the economy's money supply, currency and interest rates through the open market operations, buying and selling financial instruments, and setting the reserve requirement and the discount rate. These tools are used to induce firm's and household's portfolio adjustment. This mechanism works through the banking sector as the transmission agent of monetary policy signals. The effectiveness of monetary policy depends on the timing and the credibility of announcements and the willingness of the banks to transmit the signals as they receive them. Credibility depends on the success of the previously implemented monetary policies, as reputation is an important element in the strength of implementation of monetary policy. It also depends

on the degree of independence of the central bank from the rest of the government. The objectives of the government as policy makers and the private banking sector must align in order to ensure the effectiveness of the monetary policy. When the banking sector does not transmit the increased liquidity to the rest of the private sector and consumers, but instead uses the liquidity to expand its own bottom line, then the transmission mechanism loses its potency. For example, the excess in reserves arising from a lowering of the reserve requirements may be used by the banking sector to buy government bonds instead of lending to the private sector to increase consumption and investment. As a result, the effect of the monetary policy may not be achieved.

2.2 Fiscal Policy

Fiscal policy influences economic activities through the use of the government's power to tax and spend. In most situations, when government spending increases but revenues do not increase commensurately, governments finance the resulting shortfalls (budget deficits) by increasing borrowing, raising taxes, or both. In cases where high government borrowings create a drag on the economy, the solution recommended is of austerity, higher taxes, and lower spending. This requires a strong political consensus and, if that is successful, domestic demand contracts and growth declines unless private investment increases. Increased borrowing by issuing bonds or long-term government debt also do not appear to be desirable solutions as they increase vulnerability to shocks, create a burden on future tax payers, and have adverse distributional implication (Othman & Mirakhor, 2013).

When growth is below potential, recommended solution is to inject a stimulus in the form of increased government spending – which is usually financed through borrowing, and/or reducing taxes. In theory, a stimulus to spur economic activity during slow-downs is supposed to be financed by subsequent growth. However, more often than not, the current and prospective rates of growth of the economy may not be large or fast enough to validate debt levels that may exceed 50 percent of GDP--as is the case today in many advanced countries—that grow at a faster rate than the rate of growth of the economy.

The current public sector interest rate based borrowing policy has placed countries in a highly leveraged position. As borrowing increases, the country runs the risk of producing income only to service the interest on debt. As borrowing continues to fund increasing government spending, the problem will be passed on to future generations of taxpayers. When government borrowings are funded externally, the problem is exacerbated by outflow of resources for debt servicing that will add pressure to the balance of payments and exposes the economy to the risk of shock of "sudden stop" of external

credit as was the case during 1997/1998 Emerging Market Crisis. So far, the solution to the problem has come in the form of providing more loans to help countries out of their debt problem. A question arises whether solving a debt crisis with more debt is the right solution to the problem.

3. Impetus for Reform

Major economies of the world are currently facing a debt crisis. As a result, the Eurozone is resorting to fiscal tightening and more recently Japan had taken similar measure. At the core of a debt crisis is the interest rate based financial system. John Maynard Keynes had expressed doubts about the sustainability of a system based on the interest rate debt financing as early as 1930s. Keynes argued that market capitalism, left to it-self, would create "two evils": unemployment and poor income and wealth distribution which, if not addressed, would cause system failure. The "villain of the piece" Keynes indicated was the interest rate (cf: Abbas Mirakhor & Krichene, 2009).

3.1 Debt and the Interest Based System

An intrinsic feature of the interest rate based system is that the risks of a debt transaction are transferred from the lender to the borrower. The principal of the loan and the return to the lender is guaranteed, regardless of the outcome of the business undertaking of the borrower. The property rights to the money lent remains with the lender, as the borrower is contractually obligated to return the principal together with an additional sum, the interest. The compounding of interest exacerbates the situation leading to adverse consequences for income and wealth distribution.

The high level of debt constrains government's ability to take on additional risk on its balance sheet. Persistent fiscal deficits also impair the ability of the policymakers to respond effectively to future shocks.

3.2 Adverse Effect on Distribution of Income and Wealth

Additionally, there is adverse distributional impact from increasing debt burden not only for the present but also for the future generations. This is due to the fact that the middle and lower income classes carry the burden of the taxes that are needed to service government debt, held by either the higher income groups or the foreign creditors. As the debt service burden of the government increases, the tax rate may have to be increased or government spending, such as subsidies reduced, to pay the debts due. Under a tax system that favours the rich, tax hikes and/or reduction in subsidies worsen the income inequality.

3.3 Financial Decoupling

The use of interest rate as a tool for monetary policy creates incentives for financial decoupling. The borrower's promise to repay the principal together with the interest over a stipulated timeframe cuts off the relationship between

the project for which the funds are needed and financing. Over time, this process leads to the rapid growth of the financial sector compared to the real sector of the economy. The financial sector whose original purpose is to serve the real sector, takes a life of its own and is gradually decoupled from the real sector. This creates a phenomenon known as "financialization" that results in a divergence between the real sector and the financial sector of the economy (Askari, *et.al*., 2012; Mirakhor, 2010; Othman & Mirakhor, 2013). The current fractional reserve banking system that allows multiple amounts of money to be created out of a given amount of deposits is at the origin of the creation of expanded credit, debt and high leverage that far exceed the needs of the growth of the real sector ultimately leading to the decoupling process. This phenomenon renders the economic system unstable as the liability of the economy becomes a large multiple of the real assets (not paper claims) available to validate them (Mirakhor, 2011).

Within the context of a fractional reserve banking system, the role of the central bank in the course of implementing its monetary policy makes the current conventional financial system unstable and vulnerable to financial turmoil through the expansion of credit out of "thin air." Interest rates set by the central bank create a wedge between the money interest rate and the rate of return to the real sector of the economy (natural rate of interest[2]). It allows money capital to multiply independently of real or physical output. Creation of credits not backed by real economy diverts savings from productive activities to non-productive activities that in turn weakens the process of real wealth expansion. Eventually, it creates an economy which James Tobin called a "paper economy"(Tobin, 1984).

3.4 Fiscal Policy and Taxation

Apart from monetary policy, the government uses fiscal policy to stabilize the economy. One of the tools, taxation, has been used to influence economic activities through its effect on the disposable income, hence consumption. In a situation where the economy needs to be stimulated, taxes are reduced so that consumption is invigorated. The purpose of collecting tax is to finance government expenditure to run the administration of the country and provide public goods and services.

A tax system can either be progressive, proportional or regressive. Progressive tax schemes impose lower tax rates on lower incomes and then the tax rate becomes progressively higher for the middle to upper class brackets. Regressive tax schemes reverse this order and proportional or flat-rate tax schemes charge all income classes the same percentage. The

[2] Natural interest rate is the rate of interest at which the demand for funds of the real sector exactly equals the supply of savings.

design and structure of the tax system has an influence on the effectiveness of tax revenue generated for the government.

A complex tax structure is difficult to comprehend and challenges its compliance. At the same time, it provides incentives for shrewd taxpayers to find loopholes in the law to avoid or reduce tax payments. Intuitively, the higher the marginal tax rate that a person has to pay, the higher is the incentive to avoid taxes as any additional dollar reported brings him closer to the next tax bracket. This is particularly so in the case of a progressive tax system.

Many countries in the world have adopted the progressive tax system. It builds on the idea that as income is a measure of someone's ability to pay, the higher income group should have a higher share of tax contribution to reduce income differences among taxpayers. The tax collected from the rich that is spent on welfare programmes for the poor narrows income differences. At first glance, a progressive tax rate seems to improve equality. However, upon careful analysis, in certain tax environment or circumstances, a progressive tax rate may not achieve the desired outcome. For example, progressive tax generates less revenue when the majority of taxpayers are in the low and middle-income groups and when exemptions are given on certain items of income; its benefits favour higher income more than the lower income group. Inflation disadvantages lower income taxpayer under current progressive tax rate. The higher income group also has the incentive and means to engage in tax planning schemes with the help of tax experts and consultants. Therefore, it is arguable that a progressive tax system may not lead to income equality it purports to achieve.

Tax can either be a direct tax on income and profits or indirect tax on consumption such as value added tax (VAT) and goods and services tax (GST). The latter is a broad-based tax that is capable of generating much revenue for the government and has been adopted by many developed and developing countries. However, one major criticism of this tax is that it is imposed on everyone regardless of income level and hence may be regressive and recessionary. Unlike direct tax, where the amount paid is based on the income level of individuals, consumption tax--especially on basic goods such as clothing, transportation and food--is mostly the same for the rich and the poor. VAT (or GST) adversely affects the income groups that have lower purchasing power. They have to pay a higher price for most items they consume similar to the high-income earners. It is arguable that such taxes may dampen consumption--as people delay or reduce their consumption of goods--needed to boost economic activity and employment. A study by Palil & Mustapha (2011) showed that there is a general belief among the public that the imposition of GST would increase prices of goods and services.

Proponents of VAT (or GST) argue that the generation of information on transaction chains in such tax system is useful in enhancing the probability of detection of informal activities as well as closing the information gaps and preventing cheating, especially when a well-designed income tax and VAT/GST are operating in tandem. Question arises, granted the usefulness of this information, why should the poor be saddled with its cost? Moreover, because of the "tax interaction effects" between income tax and VAT/GST, the well-meaning presence of special provisions and exemptions in most VAT/GST and income tax system put in place to protect the interests of the poor or special interest groups increases the incentive to cheat (Ahmad, Best, & Pöschl, 2012).[3] Whilst a well-designed income tax and VAT/GST tax system is argued to be an efficient tax system for maximizing revenue collection, in developing middle-income societies it is almost impossible not to introduce compensatory measures (such as exemptions) in a VAT/GST system. The absence of these compensatory measures has implications not only for the cost of living of the population but would also make the measure politically unpopular. As such, it is arguable that a VAT/GST system may not be feasible in terms of achieving equity and fairness in taxation.

3.5 Economic Development

Macroeconomic policies are devised to achieve economic growth with price stability. More recently, however, the growth of an economy has been thought of in terms of improving the quality of life. Increasingly, contemporary discussions on economic development have placed more emphasis on human development and economic justice. Macroeconomic policies are beginning to take cognizance of social and environmental elements as integral parts of the policy decision process. Therefore, policy tools that provide an incentive structure for enhancing social solidarity through the mutual sharing of risks and returns are needed to achieve the envisaged economic development.

4. Literature Review

A study by Kharas & Gill, (2007) 'An East Asian Renaissance: Ideas for Economic Growth' suggests that, for middle-income countries, keeping equity considerations in mind while designing and implementing public policies is likely to be good for long term growth. This is because the benefits of growth of economic as well as social opportunities have to be shared widely in order to leap to a developed country status. Much of the recent literature on debt highlights its undesirable nature that transfers risk of the financier to the borrower. As opposed to a system where resources and risks are borne by operators individually, a system that pool resources be it

[3] For more detailed work on presence of informality in developing countries, please refer to Ahmad *et al.*, (2012) and Ahmad & Best, (2012).

financial, entrepreneurial or technical, will result in greater output and larger profits.[4] Additionally, Askari *et al*., (2012) provided justification for risk sharing as a viable alternative for the design of a financial system and argued that the risk sharing principle creates a close tie between the real and financial sectors of the economy. Shiller, (2003, 2009) pointed out that massive risk sharing can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. He suggested design and development of risk sharing securities which he calls “macro market” instruments.

The moral dimension to risk sharing is its ability to strengthen social solidarity by enhancing cooperation among all economic agents and expanded financial inclusion (Askari *et al*., 2012). Islām, in particular, has provided the ways and means by which uncertainties of life can be mitigated. First, it has provided a network of rules of behavior and their commensurate payoffs. Complying with these rules reduces uncertainty. Second, Islām has provided ways and means by which people are able to mitigate uncertainty of life for the less able through sharing the risks they face by engaging in economic activities with fellow human beings through exchange. Sharing allows risk to be spread and thus lowered for individual participants (Abbas Mirakhor, 2012). Therefore, a macroeconomic policy framework based on instruments of risk sharing is the main theme of the policy reform proposed in this paper.

A study by Reinhart & Rogoff, (2009) suggested that all crises of the past have been, at their core, debt crises, regardless of whether they were labelled as “currency” or “banking” crises. It is also estimated that there are about US $ 200 trillion worth of paper securities in the global economy of which US $ 150 trillion are interest rate-based debt instruments (Rogoff, 2011). Continued transfer and shifting of risk with interest rate-based debt instruments are not serving the collective welfare. Risk sharing could well provide an efficient replacement (Mirakhor, 2012).

Previous literatures have discussed the use of non-interest monetary policy. Mirakhor (1993) analysed an economy in which there might be no interest bearing assets, only equity shares. He presented an open-economy model to analyze the effects of trade in goods and assets on the macroeconomic equilibrium of the economy. He pointed out that the absence of interest bearing assets does not hamper macroeconomic analysis or the workings of the economic system. Mirakhor & Zaidi, (1991) developed an Islāmic macroeconomic model of economy to analyze the link between financial and real sectors in an open economy with a flexible exchange rate regime, and investigated the growth implication of the model. Instruments of

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[4]Abbas Mirakhor: *Whither Islamic Finance? Risk Sharing in an Age of Crises* (2010) and *Risk Sharing and Public Policy* (2011) extensively discussed the concept of risks and risk sharing.

monetary control based on equity have been proposed by Choudhry & Mirakhor, (1997). The paper discussed the indirect instruments of monetary control in a market oriented Islāmic financial system. They proposed equity based government securities with rates of return based on budgetary surplus. Such securities when utilized as instruments of monetary control enhance the role of price signals and improve market incentives.

As for fiscal policy, previous studies on policy reforms have concentrated on taxation. A good tax policy is envisioned as one that balances simplicity, efficiency, fairness and revenue sufficiency. It is one that will induce social solidarity and increase tax compliance. Given the impediments of the progressive tax structure, a flat tax system may provide an alternative. The flat tax as proposed by Hall & Rabushka, (2007) provides for a tax system which is simple and, in some aspects, fairer. The policy reform being considered will not only look at a simpler tax structure but also levy the tax based on the ability to pay. Income alone may not be a sufficient measure of well-being or taxable capacity. The possession of wealth adds to the capacity to pay tax over and above the income it yields. Therefore, in the interests of equity, it is justifiable to tax wealth in addition to income. Even though many popular contentions seem to point that wealth tax causes capital flight, its effect may not be as alarming as the perception would suggest (Hansson, 2002). A carefully implemented wealth tax on selected classes of assets may have the incentive structure that allocates idle assets to productive use. Most importantly, taxation based on ability to pay is a fairer tax system.

5. Policy Instruments in an Islāmic Economy

The ideal Islāmic finance points to a full spectrum menu of instruments serving a financial sector imbedded in an Islāmic economy in which the rules of behavior prescribed in the Qur'ān and implemented by the Beloved Messenger (pbuh), including the rules of market behavior, are fully operational (Iqbal & Mirakhor, 2011). The challenge for macroeconomic policy in an Islāmic framework is to design instruments that satisfy requirements of effective monetary and fiscal policies without resorting to the interest rate mechanism. An alternative to reliance on interest rate based instruments is to devise policy tools that rely on the risk-sharing features of equity finance.

5.1 Risk Sharing System

Profit/loss sharing and equity participation are the first best instruments of risk sharing (Iqbal & Mirakhor, 2011; Mirakhor, 2010). The presence of risk makes life uncertain, and lack of certainty can lead to paralysis in decision-making. Uncertainties of life can be mitigated by complying with the rules of behavior as provided in the Qur'ān. These rules promote risk sharing. Chapter 2, verse 275 of the Qur'ān that states "Allah has allowed exchange and

prohibited *riba*", ordains that all economic and financial transactions are to be conducted through contracts of exchange (*al-bai'*) and not through interest-based debt contracts (*riba*). Based on the order in which it appears in the verse, it can be argued that requiring contracts to be based on exchange constitutes a necessary condition "no-*riba*", the sufficient condition in an Islāmic financial system (Mirakhor, 2012). This constitutes the foundational principles of Islāmic finance. Islām considers an interest rate–based contract unfair and inequitable because it shifts the risks of financial transactions to the borrower. In the economic sphere, the rule prescribing exchange allows the risk of transactions to be shared. Sharing of risk intensifies human interaction and increases solidarity among members of the society.

Public policy plays a crucial role in creating an environment in which risk sharing will flourish and thus strengthen the institutional framework that assists in reducing individual risks. In a society, risk can be shared among its members and/or between its members and the State. The use of risk sharing instruments is the distinctive feature of the Islāmic financial and economic system.

This paper suggests that governments could issue macro market instruments that would provide their treasuries with a significant source of non-interest rate based financing while promoting risk sharing, provided that these securities meet three conditions: (i) they are low denomination; (ii) are sold on the retail market; and (iii) have a strong governance oversight (Mirakhor, 2012).

5.2 Equity Participation Shares

The first-best institution of risk sharing is the stock market. With an active stock market, individuals can buffer idiosyncratic liquidity shocks by selling equity shares in the stock market. When risk is spread among a large number of participants through an efficient stock market, closer coordination between the financial and real sector is promoted. Using the same concept, equity participation shares can be used to control the liquidity in the economy through the monetary policy mechanism and as an alternative to borrowing in financing fiscal deficit. These shares promote financial inclusion by allowing expanded participation in financing of government expenditure, such as in development projects. The shares must have low enough denominations to be purchased by the general public and be traded in secondary markets so that ordinary citizens – not just institutional investors – can have access to them.

The rate of return on these papers would be referenced to the rate of return to the real sector of the economy. Alternatively, the rate could be benchmarked against the average rate of return to the stock market, which is generally higher than the interest rate in the economy, providing investors with a better return on their savings than usual savings deposits. For example,

the current interest rate on government securities in Malaysia is between 3 to 4 per cent (depending on tenure), while the rate of return on bank deposits is 2 to 3 per cent. If the rate of return on the equity participation shares could be set to reflect the equity premium in the stock market, it could potentially earn 5 to 7 per cent.[5] Either way would represent a better investment alternative for investors than savings accounts. A major advantage of equity participation papers would be their use as a tool in monetary and fiscal policy to get the economy off continuous debt-generating ways of conducting policy.

5.3 Monetary Policy in an Islāmic Economy

As discussed, the incentive structure intended by monetary authorities to induce portfolio adjustment may be distorted if signals are not transmitted to the private sector by the banking sector. Risk-sharing instruments can avoid this problem. A distinctive feature of the Islāmic financial system is that monetary policy influences portfolio adjustments of the private sector directly through the expansion and/or contraction of the money supply. This is done through the capital market investment, rather than through the money market as in the conventional economy. Where monetary policy in a conventional economy uses interest rate to regulate the money supply, in an Islāmic economy money supply is altered through asset mark activities (Othman & Mirakhor, 2013). The liquidity in the economy can be adjusted through the issuance of financial instruments, such as equity participation shares. In an exercise to contract the money supply, these papers would be issued directly to the market to mop up excess liquidity. The effect would be more immediate than through the usual transmission mechanism of conventional monetary policy. Conversely, if the goal were to increase money supply, the monetary authority would buy these papers from the private sector. As a result, expansion in money supply has a much greater chance of resulting in expansion in real production and thus in employment and income. This feature makes monetary policy far more potent and the Islāmic financial system relatively more stable.

The effect of this policy measure would not only be to achieve greater monetary policy impact than in the conventional economy, but also to serve as a measure of improving income distribution of the society by providing better access to all members of the society to the benefits from the growth of the economy stemming from wider participation of citizens in financing government expenditures for development. It would also serve as a consumption-smoothing instrument (to mitigate idiosyncratic risk) for small investors. These participation papers must be allowed to be openly traded in

[5]This is an approximate rate of return based on the average rate of return of 11 percent after taking into account cost of issuance and the risk premium.

the secondary market so that the holders could liquidate them by selling them at the prevailing market price. This means the institutional investors such as banks would have to pay the market price in order to have access to this instrument for purposes of managing their asset portfolios. In this way, the economic opportunity of additional earnings from the financing of government developmental expenditures would be equally available to all and would not be concentrated among the more financially able only.

5.4 Fiscal Policy in an Islāmic Economy

The recent global financial crisis has revived interests in fiscal policy as an instrument for stabilizing the economy. Whether the focus is on the use of fiscal stimulus or fiscal austerity, how the government finances spending – through various kinds of taxation and borrowing – have significant implications for resource allocation and distribution. During the financial crisis, fiscal policy prescription of deficit financing through interest-based borrowing is putting countries in a highly leveraged position. An austerity measure on the other hand, is a long and painful process. An alternative approach to the current policy dilemma would propose a two-pronged solution: reform of the tax system, and a significant change in the way governments finance their spending.

As discussed above, the design of a tax system is important in generating the desired level of economic activity, revenue for the government for its spending programme and to some extent reduce the gap in income distribution. Instinctively, the simpler the tax system and the more target driven the tax is, the higher the tax compliance and revenue would be and better income distribution will be achieved. The tax system needs to be simplified to induce voluntary declaration from taxpayers, and widened based on the paying ability of the taxpayer. On this premise, a flat tax system has the features of a simple and cost efficient tax system and a tax on wealth has the potential of capturing a wider tax base. At the same time, financing of government activities should move away from the current interest-based debt system to one based on risk sharing through wider participation of the public in financing of development expenditure. Instead of borrowing, the government could issue equity participation shares, in low enough denominations and traded in secondary market, to finance the development projects. This would mobilize high private sector savings to support productive public sector investment projects (Othman & Mirakhor, 2013). In countries such as Malaysia where private savings are high, resources that are currently earning 2 per cent return could be mobilized to productive use in the economy for a higher rate of return. By issuing risk-sharing instruments to fund development expenditures, the burden of debt could be reduced. At the same time, the household sector would be able to enjoy a higher rate of return on its savings because the rate of return on the papers would be driven by the

return to the real sector. In turn, these instruments would be at the disposal of the monetary authority to send signals to the private sector when and if needed. These instruments have a number of benefits. In particular, they create flows that are not based on debt and that allow broad-based participation of the public in the activities of government. By generating increased tax revenue and tapping private sector savings, the government will not only avail itself of a source of funding for its expenditure, but also provide a more equitable opportunity for the public to have access to the wealth of the nation. The following chart illustrates the working of alternative monetary and fiscal policies:

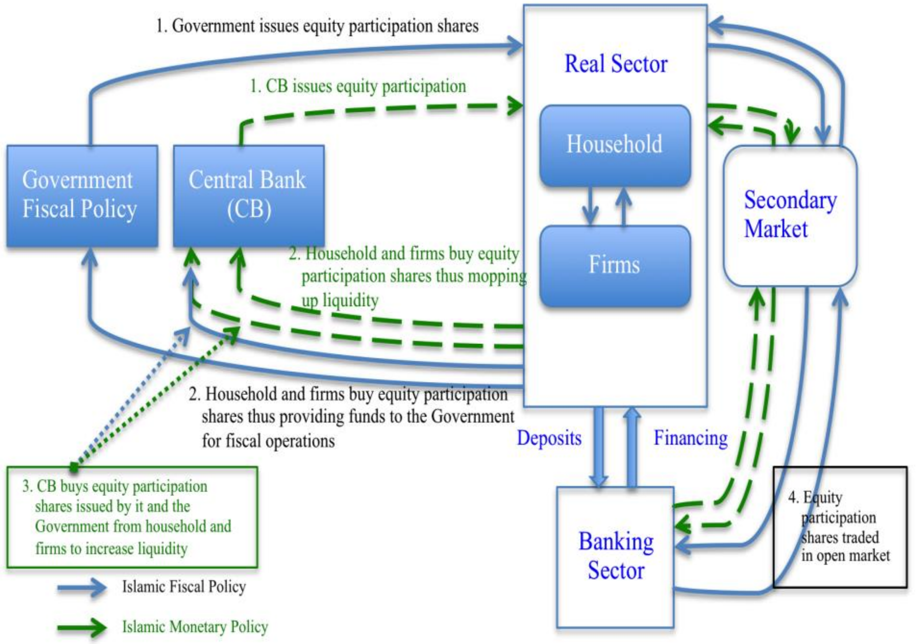

Figure 1[6]

For monetary operation (as shown by the green arrows), the central bank issues equity participation shares to contract the money supply. The purchase of these shares by the households and firms reduces liquidity in the market. For fiscal management (as shown by the blue arrows), the government will be issuing equity participation shares, which households and firms will be purchasing by using their excess funds or savings. The government then uses the proceeds to finance its development budget. Households and firms manage their liquidity by trading these papers in the secondary market. The papers issued by the government also serve as an instrument for monetary

[6] Based on Othman & Mirakhor, (2013).

operation whereby the central bank can purchase these papers to inject liquidity into the market.

6. Policy Recommendations and Implications

The result of this study should hopefully provide guidance to policy makers on the possible ways to address the challenges of macroeconomic management. As discussed, monetary policy has to move away from interest based targeting and bypass intermediation of the rent-seeking moneylenders. At the same time, fiscal consolidation may need to look beyond the usual fiscal measures of increasing taxes and widening the tax base (regardless of ability to pay) and increasing borrowing on interest (regardless of the distributional implications). The proposed framework has the following elements:

a) A monetary policy that is altered through asset mark activities and direct private sector portfolio adjustments.

b) A tax structure that can improve the tax revenue.

c) Public sector financing that mobilises non-debt-creating sources to finance development expenditure.

The benefit from the proposed policy reform is a positive distributional impact on income and wealth where:

- Monetary easing and contraction through portfolio adjustment will reach directly to the target agents.
- There will be better alignment of financial and real sector growth.
- The use of equity participation shares provides a more equitable opportunity to access the wealth of the nation and this will be provided to all regardless of status.
- The risk-sharing feature of the policy reform will forge a much closer connection between the financial and the real sectors thus imparting greater stability and resilience to the economy.
- Increased development expenditure funded by the risk-sharing instruments will generate growth of GDP.
- The participants can reduce the risk of income volatility and allow consumption smoothing that may increase the welfare of society.
- The reform in public sector financing would mean the burden of debt is no longer imposed on the taxpayers, and the future generation is safeguarded from shouldering the debt of the current generation.
- A simple tax structure offered by flat tax system reduces the incentive to avoid or manipulate tax calculation. Higher tax compliance with a simpler tax system will bring more people into the tax net and increase tax revenue to the government. It will also lead to reduction in the

administrative costs of tax payment and collection to the taxpayer and government respectively as well as do away with cost of tax disputes in courts.

- Tax on wealth should lead to a wider tax base (so the rate can be kept low) and the burden of tax is shifted to those who have a higher ability to pay (as opposed to GST which hits the poor and rich alike). The burden of tax is distributed based on eligibility to pay.
- The impact of the proposal could further strengthen social solidarity as sharing of risks increases cooperation and coordination among the people and between the people and the government.
- Participations of the public with the government in development expenditure will enhance the governance structure of the government, as the government would be more accountable to the general public on their development spending. Improved governance will enhance trust and transparency.

The choice of the above policy reform is based on its ability to achieve the objectives of an ideal Islāmic economy: social justice and equity, trust and transparency, cooperation and coordination through sharing of risks, a more equitable distribution of income and finance grounded in the real economy.

7. Conclusions

This concept paper proposes a new framework for macroeconomic policy that seeks to address the challenges that have created instability in the global economy. The use of risk sharing instruments as tools of monetary and fiscal policy has the potential of promoting socio-economic development and human well-being by the justice and equity features of sharing of risks. One of the main challenges to reforming the current policy structure is steering out of the "path-dependency" created by the elements of interest rate-based debt financing paradigm ingrained in the financial system in the economy.[7] However, if these Islāmic-based policies can be framed correctly in terms of their potential benefits that outweigh the perceived costs of reform, it may attract wide public acceptance. Islāmic finance must be understood as a system that promotes human dignity, social solidarity, and close correspondence between the real and financial sectors with potent fiscal and monetary policies.

[7]Path-dependency is the continued use of a product or practice based on historical preference or use. This persistent pattern holds true even if newer, more efficient products or practices are available because of the previous commitment made. Path-dependency occurs because it is often easier or more cost-effective to simply continue along an established and known path than to create an entirely new one (see Investopedia).

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